

Message Text

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ACTION EUR-12

INFO OCT-01 EA-12 IO-14 ISO-00 AID-05 CIAE-00 EB-08
FRB-01 INR-10 NSAE-00 USIA-15 XMB-04 OPIC-06
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CEA-01 PA-02 ABF-01 /127 W
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P R 151213Z MAR 78
FM AMEMBASSY LONDON
TO SECSTATE WASHDC PRIORITY 4157
TREASURY DEPT WASHDC PRIORITY
INFO AMEMBASSY BONN
AMEMBASSY BRUSSELS
AMEMBASSY DUBLIN
AMEMBASSY PARIS
AMEMBASSY ROME
AMEMBASSY TOKYO
AMCONSUL BELFAST
AMCONSUL EDINBURGH
USMISSION GENEVA
USDOC WASHDC

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USEEC ALSO FOR EMBASSY
USOECD ALSO FOR EMBASSY
USMTN

DEPARTMENT PASS FEDERAL RESERVE BOARD; TREASURY FOR
DONALD E. SYVRUD, OASIA

E.O. 11652: N/A
TAGS: ECON, UK
SUBJECT: REACTION TO THE U.S.-GERMAN MARCH 13 STATEMENT
ON THE DOLLAR

SUMMARY: MARKETS AND PRESS COMMENT HAVE WELCOMED THE
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STATEMENT AND THE MEASURES, BUT THEY SEE THEM AS A PALIATIVE RATHER THAN A CURE TO THE DOLLAR PROBLEM; THE FUNDAMENTALS REMAIN TO BE DEALT WITH. END SUMMARY.

1. FOREIGN EXCHANGE DEALERS APPEAR PLEASED WITH THE SPIRIT OF THE PACKAGE, AT LEAST THE U.S. AND GERMANY ARE COOPERATING. THE U.S. CANNOT BE ACCUSED OF BENIGN NE-

GLECT, BUT THIS SAID, WHAT HAS CHANGED IN A FUNDAMENTAL WAY? AN OFT-REPEATED LINE WAS "OK; YOU ARE BORROWING MONEY TO DEFEND YOUR POSITION, BUT WHAT ARE YOU DOING TO IMPROVE IT?"

2. FOLLOWING ARE EXCERPTS FROM EDITORIALS OF MARCH 14 IN THE FINANCIAL TIMES (RAISING THE DOSAGE) AND THE TIMES (BUYING TIME FOR THE DOLLAR).

3. EXCERPTS FROM FINANCIAL TIMES EDITORIAL:

RAISING THE DOSAGE. IF A DOCTOR FINDS THAT THE TREATMENT HE HAS PRESCRIBED HAS PRODUCED NO IMPROVEMENT IN THE PATIENT, HE WILL TRY TO FIND SOME OTHER REMEDY. THE GERMAN AND AMERICAN AUTHORITIES, WITH A SAD LACK OF IMAGINATION, HAVE SIMPLY PRESCRIBED A FURTHER DOSE OF THE SAME MEDICINE; IT IS HARDLY SURPRISING THAT THE MARKETS HAVE DECIDED THAT THE DOLLAR IS LIKELY TO REMAIN ABOUT AS SICK AS BEFORE. IT IS TRUE THAT THERE IS ALSO THE PROMISE THAT A SLIGHTLY DIFFERENT FORMULATION IS NOW AVAILABLE IN RESERVE: THE AMERICANS HAVE UNDERTAKEN TO BORROW ON THEIR OWN ACCOUNT THROUGH THEIR IMF DRAWING RIGHTS IF THEY REQUIRE TO, THUS SHOULDERING PART OF THE EXCHANGE RISK. THE CHANGE HAS BEEN TOO SMALL TO ALTER THE OUTLOOK.

UNDERSTANDING. IT MAY BE THAT ON FURTHER REFLECTION HOLDERS WILL DECIDE THAT SINCE THE U.S. AUTHORITIES ARE UNCLASSIFIED

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AT LAST COMMITTED TO SOME CONCERN ABOUT THE FUTURE OF THE EXCHANGE RATE, THE DANGERS HAVE AFTER ALL BEEN SOMEWHAT REDUCED, AND THAT THE CURRENCY WILL REMAIN SOMEWHERE NEAR ITS PRESENT LEVEL RATHER THAN RESUMING ITS PRECIPITOUS DECLINE.

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SO FAR AS THE DOLLAR IS CONCERNED, THERE IS STILL NO SIGN THAT THE AMERICAN AUTHORITIES RECOGNIZE THAT EXCHANGE RATE WEAKNESS, WHICH IS ESSENTIALLY A MONETARY PROBLEM, CAN ONLY BE CURED BY MEASURES WHICH INVOLVE MONETARY POLICY. THE BALANCE OF PAYMENTS PROBLEM APPEARS TO BE WELL UNDERSTOOD: IT IS PARTLY CYCLICAL, AND PARTLY STRUCTURAL. BORROWING IS AN APPROPRIATE WAY TO FINANCE A CYCLICAL DEFICIT, AND THE CARTER ADMINISTRATION IS TRYING TO TACKLE SOME OF THE STRUCTURAL CAUSES AS FAST AS CONGRESS WILL ALLOW.

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... THE MONETARY BACKGROUND WILL ONLY COME RIGHT IF THE FED REALISES THAT WHEN CENTRAL BANK INTERVENTION IS THE RULE, AND EXCHANGE RATE STABILIZATION THE AIM, THEN POTENTIAL MONEY GROWTH, MEASURED THROUGH DOMESTIC CREDIT, RATHER THAN THE ACTUAL GROWTH OF THE MONEY SUPPLY, IS THE

APPROPRIATE YARDSTICK FOR POLICY. ...

4. EXCERPTS FROM THE TIMES EDITORIAL:

YESTERDAY'S COMMUNIQUE FROM THE AMERICAN AND GERMAN
GOVERNMENTS ABOUT THE DOLLAR SHOULD BE WELCOMED AT ONE

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LEVEL AS EVIDENCE THAT THESE TWO COUNTRIES WISH TO LEAD
A COOPERATIVE EFFORT TO OVERCOME THE WORLD'S ECONOMIC AND
MONETARY PROBLEMS. IN THE LAST YEAR EVIDENT TENSIONS BETWEEN
THE UNITED STATES AND WEST GERMANY HAVE BEEN A GROWING
SOURCE OF CONCERN IN THIS RESPECT. IN RECENT MONTHS
A GENERAL LACK OF WILL TO TACKLE THE CENTRAL PROBLEMS OF
RECESSION, INFLATION AND MONETARY DISORDER HAVE PUT AT
RISK THE BONN ECONOMIC SUMMIT MEETING, SCHEDULED FOR
JULY. AFTER YESTERDAY'S ANNOUNCEMENT, IT SEEMS MORE LIK

LY THAT THE BONN MEETING WILL BE MADE TO SEEM A SUCCESS
FOR COOPERATIVE INTERNATIONAL EFFORT.

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IN THE CASE OF THE DOLLAR, IT IS LEGITIMATE TO ASK
WHETHER THE RESPONSE BY THE AMERICAN AND GERMAN GOVERN-
MENTS PROVIDES EVIDENCE THAT THE CENTRAL PROBLEMS HAVE
BEEN ADEQUATELY RECOGNIZED. INCREASED SWOP ARRANGEMENTS
AND ENLARGED INTERVENTION BY CENTRAL BANKS IN FOREIGN
EXCHANGE MARKETS CANNOT AFFECT UNDERLYING REALITIES. ALL
THAT SUCH CONVENTIONAL RESPONSES CAN DO, AS SUCCESSIVE
BRITISH GOVERNMENTS THROUGH SUCCESSIVE STERLING CRISES
FOUND, TO THEIR COST, IS TO BUY TIME.

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... FOR THE CENTRAL PROBLEM OF THE DOLLAR NOW RE-
LATES TO ITS WEAKNESS AS AN INTERNATIONAL RESERVE CUR-
RENCY. SINCE THE EXTERNAL SECTOR IS SUCH A SMALL PART
OF THE AMERICAN ECONOMY NO AMERICAN GOVERNMENT HAS BEEN
WILLING TO ALLOW CONCERN FOR THE EXTERNAL VALUE OF ITS
CURRENCY TO AFFECT SUBSTANTIALLY DOMESTIC ECONOMIC POLICY
AT THE SAME TIME THE DOLLAR HAS YEAR BY YEAR TAKEN ON AN
INCREASING SHARE OF THE ROLE AS THE CENTRAL PART OF THE
INTERNATIONAL RESERVE SYSTEM, AND THE AMERICAN DOMESTIC
ECONOMY HAS BECOME A STEADILY SMALLER PROPORTION OF THE
WORLD ECONOMY.

FOR THIRTY YEARS IT SUITED THE DEVELOPMENT OF THE
WORLD THAT THIS PROCESS SHOULD UNDERPIN ECONOMIC GROWTH.
AMERICAN GOVERNMENTS HAVE RESISTED THE IDEA THAT THEY
SHOULD TAKE DIRECT RESPONSIBILITY FOR THE INTERNATIONAL
WORTH OF THE DOLLAR, FOR THE OBVIOUS REASON THAT ANY SUCH
ADMISSION WOULD IMPLY COSTS FOR THE AMERICAN ECONOMY,
WHICH "BENIGN NEGLECT" AVOIDS.

THE RESULT NOW IS THAT WE HAVE AN INCREASINGLY UN-
STABLE SYSTEM OF INTERNATIONAL LIQUIDITY BASED LARGELY
ON A DOLLAR WHICH IS IN SUBSTANTIALLY EXCESS SUPPLY.
ANY POLICY THAT FAILS TO RECOGNIZE AND REACT TO THIS
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CENTRAL FACT HAS NO CHANCE OF LONG-TERM SUCCESS. IN
THE END, THE DOLLAR BALANCES WILL HAVE TO BE FUNDED INTO
SOME RESERVE ASSET WHICH PRESENT OWNERS OF PORTFOLIOS
OVERLOADED WITH DOLLARS FIND MORE ATTRACTIVE.

GIVEN THE SCALE OF THE DOLLAR PROBLEM, SUCH A FUND-
ING OPERATION WILL REQUIRE A MAJOR INITIATIVE IN POLITI-
CAL LEADERSHIP OVER A LONG PERIOD. THE ALTERNATIVE, HOW

EVER, IS A WORLD SYSTEM BASED LARGELY ON A CURRENCY WHICH
IS INCREASINGLY DISTRUSTED. SUCH A SYSTEM WOULD BE
BOUND TO LURCH FROM INCREASING CRISIS TO INCREASING
CRISIS. IF THE BONN SUMMIT IN THE SUMMER BEGINS TO FACE
THIS CENTRAL ISSUE, THEN AT LAST THE LEADERS OF THE IN-
DUSTRIAL WORLD WILL HAVE BEGUN TO MAKE PROGRESS.

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